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SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 210

[Release No. 33-9929; 34-75985; IC-31849; File No. S7-20-15]

Request for Comment on the Effectiveness of Financial Disclosures about Entities Other Than the Registrant

AGENCY: Securities and Exchange Commission.

ACTION: Request for comment.

SUMMARY: The Commission is publishing this request for comment to seek public comment regarding the financial disclosure requirements in Regulation S-X for certain entities other than a registrant. These disclosure requirements require registrants to provide financial information about acquired businesses, subsidiaries not consolidated and 50 percent or less owned persons, guarantors and issuers of guaranteed securities, and affiliates whose securities collateralize registered securities. This request for comment is related to an initiative by the Division of Corporation Finance to review the disclosure requirements applicable to public companies to consider ways to improve the requirements for the benefit of investors and public companies.

DATES: Comments should be received on or before [Insert date 60 days after publication in the Federal Register].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/other.shtml>);

or

- Send an email to rule-comments@sec.gov. Please include File Number S7-20-15 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper comments:

- Send paper comments to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-20-15. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method of submission. The Commission will post all comments on the Commission's website (<http://www.sec.gov/rules/other.shtml>). Comments also are available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: Todd E. Hardiman, Associate Chief Accountant, at (202) 551-3516, Division of Corporation Finance; Duc Dang, Special Counsel, at (202) 551-3386, Office of the Chief Accountant; or Matthew Giordano, Chief Accountant, at (202) 551-6892, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

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I. Introduction

Over the years, the Commission has considered its disclosure system and engaged periodically in rulemakings designed to enhance our disclosure and registration requirements. Some requirements have been considered and updated relatively frequently, while others have changed little since they were first adopted. For example, the Commission has revised the registration requirements a number of times, most recently in 2005 with Securities Offering Reform, and at that time, the Commission also adopted new methods of communicating offering information.¹ As another example, the disclosure requirements applicable to small businesses also have been updated on a variety of occasions, most recently in 2007.² In contrast, other requirements in Regulations S-K³ and S-X,⁴ which encompass many of the Commission's financial and non-financial disclosure rules, have not been updated frequently.

In 2013, the staff issued its *Report on Review of Disclosure Requirements in Regulation S-K*,⁵ which was mandated by Section 108 of the Jumpstart Our Business Startups Act (the "JOBS Act").⁶ Section 108(b) of the JOBS Act required the Commission to submit a report to Congress including the specific recommendations of the Commission on how to streamline the registration process in order to make it more efficient and less burdensome for the Commission and for prospective issuers who are emerging growth companies. The Commission staff

¹ See *Securities Offering Reform*, Release No. 33-8591 (July 19, 2005) [70 FR 44722].

² See *Smaller Reporting Company Regulatory Relief and Simplification*, Release No. 33-8876 (Dec. 19, 2007) [73 FR 934].

³ 17 CFR 229.10 *et seq.*

⁴ 17 CFR part 210.

⁵ *Report on Review of Disclosure Requirements in Regulation S-K* (Dec. 2013), available at <http://www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf>. Section 108(a) of the JOBS Act directed the Commission to conduct a review of Regulation S-K to (1) comprehensively analyze the current registration requirements of such regulation; and (2) determine how such requirements can be updated to modernize and simplify the registration process and reduce the costs and other burdens associated with these requirements for issuers who are emerging growth companies.

⁶ Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

recommended the development of a plan to systematically review the disclosure requirements in the Commission's rules and forms, including both Regulation S-K and Regulation S-X, and the presentation and delivery of information to investors and the marketplace. At the time the report was issued, Commission Chair Mary Jo White asked the staff to develop specific recommendations for updating the rules that dictate what a company must disclose in its filings.⁷ Pursuant to this request, the staff is undertaking a broad-based review of the disclosure requirements and the presentation and delivery of the disclosures, which the Commission may consider whether to review. This ongoing review by the staff is known as the Disclosure Effectiveness Initiative.

Initially, the staff is focusing on the business and financial information that is required to be disclosed in periodic and current reports, namely Forms 10-K, 10-Q and 8-K, and registration statements.⁸ As part of the review, the staff requested public input,⁹ and received a number of comments. Two of the comment letters addressed Regulation S-X,¹⁰ which is the subject of this request for comment and the first product resulting from the Disclosure Effectiveness Initiative.

Regulation S-X contains disclosure requirements that dictate the form and content of financial statements to be included in filings with the Commission. It addresses both registrant financial statements and financial statements of certain entities other than the registrant. As an

⁷ See SEC Press Release 2013-269, dated December 20, 2013, available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540530982>.

⁸ See Keith F. Higgins, Disclosure Effectiveness: Remarks Before the American Bar Association Business Law Section Spring Meeting (April 2014), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370541479332>.

⁹ See request for public comment at <http://www.sec.gov/spotlight/disclosure-effectiveness.shtml>.

¹⁰ See letter from Thomas J. Kim, Chair, Disclosure Effectiveness Working Group of the Federal Regulation of Securities Committee and the Law and Accounting Committee, Business Law Section, American Bar Association, November 14, 2014 available at <http://www.sec.gov/comments/disclosure-effectiveness/disclosureeffectiveness-23.pdf>; but see letter from Sandra J. Peters and James C. Allen, CFA Institute, November 12, 2014 available at <http://www.sec.gov/comments/disclosure-effectiveness/disclosureeffectiveness-24.pdf>.

initial step in the review of Regulation S-X, we are considering the requirements applicable to these other entities, which is a discrete, but important, subset of the Regulation S-X disclosure requirements. The staff is continuing to evaluate other Regulation S-X disclosure requirements applicable to the registrant and how those requirements integrate with, for example, Regulation S-K and the applicable accounting standards and will make further recommendations to the Commission for consideration. In this request for comment, we are seeking public comment on the following rules, along with certain related requirements:

- Rule 3-05, Financial Statements of Businesses Acquired or to be Acquired;¹¹
- Rule 3-09, Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons;¹²
- Rule 3-10, Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered;¹³ and
- Rule 3-16, Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered.¹⁴

We seek to better understand how well these requirements, some of which have remained largely the same for many years,¹⁵ are informing investors and we are soliciting comment on how investors use the disclosures to make investment and voting decisions. We are also interested in learning about any challenges that registrants face in preparing and providing the required disclosures. Finally, we are interested in potential changes to these requirements that

¹¹ 17 CFR 210.3-05.

¹² 17 CFR 210.3-09.

¹³ 17 CFR 210.3-10.

¹⁴ 17 CFR 210.3-16.

¹⁵ Rule 3-05 has not been thoroughly reconsidered since 1996. *See Streamlining Disclosure Requirements Related to Significant Business Acquisitions*, Release No. 33-7355 (Oct. 10, 1996) [61 FR 54509]. Rules 3-09 and 3-16 have not been thoroughly reconsidered since 1981. *See Separate Financial Statements Required by Regulation S-X*, Release No. 33-6359 (Nov. 6, 1981) [46 FR 56171]. Rule 3-10 was substantially revised in 2000. *See Financial Statements and Periodic Reports for Related Issuers and Guarantors*, Release No. 33-7878 (Aug. 4, 2000) [65 FR 51692].

could enhance the information provided to investors and promote efficiency, competition, and capital formation.¹⁶

To focus the discussion, this request for comment describes the requirements¹⁷ that apply to domestic registrants¹⁸ that do not qualify as smaller reporting companies¹⁹ or emerging growth companies.²⁰ When relevant, we note different disclosure requirements triggered by each type of registrant.²¹ In addition, unless otherwise noted, the disclosure requirements we describe in this request for comment should be assumed to apply to periodic reporting under the Exchange Act and registration statements filed under the Exchange Act and the Securities Act.

¹⁶ Section 3(f) of the Securities Exchange Act of 1934 (“Exchange Act”) [15 U.S.C. 78a *et seq.*] requires that, whenever the Commission is engaged in rulemaking under the Exchange Act and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall consider, in addition to the protection of investors, promotion of efficiency, competition and capital formation. Section 2(b) of the Securities Act of 1933 (“Securities Act”) [15 U.S.C. 77a *et seq.*] also sets forth this same requirement. See also Section 23(a)(2) of the Exchange Act.

¹⁷ The descriptions in this release are provided for the convenience of commenters and to facilitate the comment process. The descriptions should not be taken as Commission or staff guidance about the relevant rules.

¹⁸ Generally, the requirements described in this release apply to entities registered as investment companies and entities that have elected to be treated as business development companies under the Investment Company Act of 1940 [15 U.S.C. 80a-1 *et seq.*]. See Rule 6-03 of Regulation S-X [17 CFR 210.6-03], which states in part, “[t]he financial statements filed for persons to which §§210.6-01 to 210.6-10 are applicable shall be prepared in accordance with the...special rules [§§210.6-01 to 210.6-10] in addition to the general rules in §§210.1-01 to 210.4-10 (Articles 1, 2, 3, and 4). Where the requirements of a special rule differ from those prescribed in a general rule, the requirements of the special rule shall be met.”

¹⁹ Exchange Act Rule 12b-2 [17 CFR 240.12b-2] defines a smaller reporting company as an issuer that is not an investment company, an asset-backed issuer, or a majority-owned subsidiary of a parent that is not a smaller reporting company and that has a public float of less than \$75 million. If an issuer has zero public float, it would be considered a smaller reporting company if its annual revenues are less than \$50 million.

²⁰ Section 2(a)(19) of the Securities Act defines an emerging growth company as an issuer that had total gross revenues of less than \$1 billion during its most recently completed fiscal year. It retains that status for five years after its initial public offering unless its revenues rise above \$1 billion, it issues more than \$1 billion of non-convertible debt in a three year period, or it qualifies as a large accelerated filer pursuant to Exchange Act Rule 12b-2.

²¹ For example, we indicate by footnote where different disclosure requirements apply to foreign private issuers. The definition of foreign private issuer is contained in Securities Act Rule 405 [17 CFR 230.405] and Exchange Act Rule 3b-4(c) [17 CFR 240.3b-4(c)]. A foreign private issuer is any foreign issuer other than a foreign government, except for an issuer that (1) has more than 50 percent of its outstanding voting securities held of record by U.S. residents and (2) any of the following: (i) a majority of its officers and directors are citizens or residents of the United States; (ii) more than 50 percent of its assets are located in the United States; or (iii) its business is principally administered in the United States.

II. Rule 3-05 of Regulation S-X – Financial Statements of Businesses Acquired or to be Acquired and Related Requirements

A. Current Rule 3-05 Disclosure and Related Requirements

When a registrant acquires a business, Rule 3-05 generally requires it to provide separate audited annual and unaudited interim pre-acquisition financial statements (“Rule 3-05 Financial Statements”) of the business²² if it is significant to the registrant.²³ A registrant determines whether an acquisition is significant using the investment, asset, and income tests defined in Rule 1-02(w) of Regulation S-X.²⁴ Performing these tests for purposes of applying Rule 3-05 and related requirements can be generally described as follows:

- Investment Test - the purchase consideration is compared to the total assets of a registrant reflected in its most recent annual financial statements required to be filed at or prior to the acquisition date.
- Asset Test - a registrant’s proportionate share of the business’s total assets reflected in the business’s most recent annual pre-acquisition financial statements is compared to the

²² Registrants determine whether a “business” has been acquired by applying Rule 11-01(d) [17 CFR 210.11-01(d)] of Regulation S-X. This determination is separate and distinct from a determination made under the applicable accounting standards requiring registrants to account for and disclose the transaction in a registrant’s financial statements. The definition of “business” in Regulation S-X focuses primarily on whether the nature of the revenue-producing activity of the target will remain generally the same as before the transaction. The definition in the applicable accounting standards (see Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 805, *Business Combinations* in U.S. GAAP and a similar definition in IFRS 3, *Business Combinations*) focuses on whether the target is an integrated set of activities and assets that is capable of being conducted and managed by a market participant for the purpose of providing a return.

²³ Domestic issuers file the disclosures required by Rule 3-05 and its related requirements in current reports filed on Form 8-K [17 CFR 249.308] under the Exchange Act, as well as in registration statements. Foreign private issuers, however, only file the disclosures in registration statements. In *Foreign Issuer Reporting Enhancements*, Release No. 33-8900 (Feb. 29, 2008) [73 FR 13404], the Commission proposed requiring foreign private issuers to provide certain financial information required by Rule 3-05 in periodic reports. This requirement was not adopted by the Commission. See *Foreign Issuer Reporting Enhancements*, Release No. 33-8959 (Sept. 23, 2008) [73 FR 58300].

²⁴ 17 CFR 210.1-02(w).

total assets of the registrant reflected in its most recent annual financial statements required to be filed at or prior to the acquisition date.

- Income Test - a registrant's equity in the income from continuing operations before income taxes and cumulative effect of a change in accounting principle,²⁵ as reflected in the business's most recent annual pre-acquisition financial statements, exclusive of amounts attributable to any noncontrolling interests, is compared to the same measure of the registrant reflected in its most recent annual financial statements required to be filed at or prior to the acquisition date.

Rule 3-05 requires more disclosure as the size of the acquisition, relative to the size of the registrant, increases based on the test results. If none of the Rule 3-05 tests exceeds 20 percent, a registrant is not required to file any Rule 3-05 Financial Statements. If any of the Rule 3-05 tests exceeds 20 percent, but none exceeds 40 percent, Rule 3-05 Financial Statements are required for the most recent fiscal year and any required interim periods. If any Rule 3-05 test exceeds 40 percent, but none exceeds 50 percent, a second fiscal year of Rule 3-05 Financial Statements is required. When at least one Rule 3-05 test exceeds 50 percent, a third fiscal year²⁶ of Rule 3-05 Financial Statements is required unless revenues of the acquired business were less than \$50 million in its most recent fiscal year.²⁷

²⁵ Rule 1-02(w) of Regulation S-X refers to extraordinary items, but the FASB eliminated this concept from U.S. GAAP in its Accounting Standards Update No. 2015-1, *Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items*, issued on January 9, 2015. IFRS prohibit the presentation and disclosure of extraordinary items in IAS 1, *Presentation of Financial Statements*.

²⁶ A smaller reporting company is subject to requirements similar to Rule 3-05 that are found in Rule 8-04 of Regulation S-X [17 CFR 210.8-04], but is never required to provide a third fiscal year. An emerging growth company, although subject to Rule 3-05, need not provide a third year of Rule 3-05 Financial Statements when it only presents two years of its own financial statements pursuant to Section 7(a)(2)(A) of the Securities Act.

²⁷ 17 CFR 210.3-05(b)(2).

Rule 3-05 Financial Statements must be accompanied by the pro forma financial information described in Article 11 of Regulation S-X (“Pro Forma Information”).²⁸ Pro Forma Information typically includes the most recent balance sheet and most recent annual and interim period income statements. The Pro Forma Information is based on the historical financial statements of the registrant and the acquired business and generally includes adjustments to show how the acquisition might have affected those financial statements had it occurred at an earlier time. Adjustments to the pro forma balance sheet and income statements must be “factually supportable” and “directly attributable to the transaction.” An additional criterion, “continuing impact,” applies only to adjustments to the pro forma income statement.²⁹ The adjustments are computed assuming the transaction occurred at the beginning of the fiscal year presented and carried forward through any interim period presented.³⁰

A registrant must provide a brief description of a significant acquisition by filing a Form 8-K³¹ within four business days after consummation of the acquisition. If Rule 3-05 Financial Statements and Pro Forma Information are not provided with this Form 8-K, the registrant must provide them within approximately 75 days after consummation by filing an amendment to the Form 8-K.³² The 75-day period is intended to provide sufficient time to obtain the Rule 3-05 Financial Statements and prepare the Pro Forma Information.

²⁸ 17 CFR 210.11. A smaller reporting company provides the pro forma financial information described in Rule 8-05 of Regulation S-X [17 CFR 210.8-05]. Although the preliminary notes to Article 8 indicate that smaller reporting companies may wish to consider Article 11, it is not required.

²⁹ 17 CFR 210.11-02(b)(6).

³⁰ For example, amortization expense of an acquired intangible asset would be shown in the fiscal year and subsequent interim period pro forma income statements as if the acquisition occurred on the first day of the fiscal year.

³¹ General Instruction B.1 of Form 8-K.

³² Item 9.01(a)(4) of Form 8-K requires that the amendment be filed no later than 71 calendar days after the date that the initial Form 8-K must be filed.

When filing certain registration statements,³³ a registrant may need to update, based on the effective date, Rule 3-05 Financial Statements and Pro Forma Information previously provided on Form 8-K.³⁴ A registrant must also include, in certain registration statements filed ahead of the due date of the Form 8-K, Rule 3-05 Financial Statements and Pro Forma Information for a recently-consummated acquisition when a Rule 3-05 test exceeds 50 percent.³⁵ Finally, the following additional disclosures that are not required on Form 8-K must be provided in certain registration statements:³⁶

- Rule 3-05 Financial Statements and Pro Forma Information for a probable acquisition when a Rule 3-05 test exceeds 50%; and
- Rule 3-05 Financial Statements and Pro Forma Information for the substantial majority of individually insignificant consummated and probable acquisitions since the date of the most recent audited balance sheet if a Rule 3-05 test exceeds 50 percent for any combination of the acquisitions.³⁷

The accounting standards require disclosure³⁸ to enable investors to understand the nature and financial effect of a business combination that occurs during the periods presented in the

³³ These additional requirements do not apply to all registration statements. For example, they do not apply to registration statements filed on Form S-8 [17 CFR 239.16b] or registration statements filed pursuant to Rule 462(b) of Regulation C [17 CFR 230.462(b)].

³⁴ 17 CFR 210.3-12.

³⁵ 17 CFR 210.3-05(b)(4).

³⁶ In 1996, the Commission partially conformed these reporting requirements in *Streamlining Disclosure Requirements Related to Significant Business Acquisitions*, Release No. 33-7355 (Oct. 10, 1996) [61 FR 54509] and retained these disclosures because it recognized that “an acquisition could be so large relative to an issuer that investors would need financial statements of the acquired business for a reasoned evaluation of any primary capital raising transaction by the issuer.”

³⁷ 17 CFR 210.3-05(b)(2)(i). Commission staff has clarified that certain significant acquisitions should also be included. See §2035.2 of the Division of Corporation Finance’s *Financial Reporting Manual*. This manual was originally prepared by the staff of the Division of Corporation Finance to serve as internal guidance. In 2008, in an effort to increase transparency of informal staff interpretations, the Division of Corporation Finance posted the manual to its website at <http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml>.

³⁸ See FASB ASC 805, *Business Combinations* and IFRS 3, *Business Combinations*.

registrant's financial statements or subsequent to the most recent balance sheet date, but before the registrant's financial statements are issued. Some of the disclosures required by the accounting standards are the same as those required by Rule 3-05 and the related requirements, such as the name and description of the acquired business. Others, such as pro forma financial information, are similar although the Pro Forma Information required by Article 11 of Regulation S-X is significantly more detailed. More significantly, Rule 3-05 requires historical financial statements of the acquired entity and the accounting standards do not.

B. Consideration of Current Rule 3-05 Disclosure and Related Requirements

1. Content of the Rule 3-05 Disclosure and Related Requirements

Financial disclosures required by our rules about a business acquisition are important to investors because an acquisition will result in changes to a registrant's financial condition, results of operations, liquidity, and future prospects. Depending on the impact of the acquisition, those changes could be significant. While it is important to provide investors with information about an acquisition, the types of financial information currently required under the rules may have some limitations as a predictor of the financial condition and results of operations of the combined entity following the acquisition. Prior to the adoption of Rule 3-05 in 1982, some commenters questioned the need for financial statements of acquired businesses for periods prior to the acquisition. Those commenters criticized the utility and relevance of pre-acquisition financial statements in assessing the future impacts of an acquisition on a registrant. Specifically, commenters noted that pre-acquisition financial statements do not reflect the new basis of accounting that arises upon consummation, changes in management, or various other

items affected by the acquisition.³⁹ Although the Pro Forma Information addresses some of these concerns by showing how the accounting for an acquisition might have affected a registrant's historical financial statements had the transaction been consummated at an earlier time, restrictions on pro forma adjustments prohibit a registrant from reflecting other significant changes it expects to result from the acquisition. For example, Commission staff has stated that workforce reductions and facility closings, both actions that registrants frequently take when acquiring businesses, are generally too uncertain to meet the criteria for adjustment.⁴⁰ In addition, Pro Forma Information usually lacks comparative prior periods and is unaudited. Finally, unless a registrant files certain registration statements that trigger the required disclosures earlier, investors typically must wait approximately 75 days for the Rule 3-05 Financial Statements and the Pro Forma Information.

Request for Comment

1. How do investors use each of the following: the Rule 3-05 Financial Statements; the Pro Forma Information; and the disclosures required by the applicable accounting standards? Are there challenges that investors face in using these disclosures?
2. Are there changes to these requirements we should consider to further facilitate the disclosure of useful information to investors? For example, is there different or additional information that investors need about acquired businesses or about how the

³⁹ These comments were received in connection with the proposal, *Instructions for the Presentation and Preparation of Pro Forma Financial Information and Financial Statements of Companies Acquired or to be Acquired*, Release 33-6350 (September 24, 1981) [46 FR 48943]. In the adopting release, *Instructions for the Presentation and Preparation of Pro Forma Financial Information and Requirements for Financial Statements of Businesses Acquired or to be Acquired*, Release No. 33-6413 (June 24, 1982) [47 FR 29832], the Commission considered reducing the required disclosure to condensed or summarized information. However, the Commission decided that full financial statements of an acquired business were necessary because it believed that there was important information in the notes to the financial statements that would not be reflected in condensed or summarized information and that it was essential that financial information about an acquired business be audited by an independent auditor.

⁴⁰ See §3250.1 of the Division of Corporation Finance's *Financial Reporting Manual*.

- combined entities might perform following the acquisition? If so, what information is needed and are there challenges that registrants would face in preparing and providing it?
3. Are there challenges that registrants face in preparing and providing the required disclosures? If so, what are the challenges? Are there changes to these requirements we should consider to address those challenges? If so, what changes and how would those changes affect investors' ability to make informed decisions?
 4. Are there requirements that result in disclosures that investors do not consider useful? If so, what changes to these requirements would make them useful or should we consider eliminating or replacing all or part of those requirements?
 5. How could we improve the usefulness of the Pro Forma Information? Could we do so by changing the extent of information required and/or the methodologies used to prepare it? For example, should we add a requirement for comparative pro forma income statements of the prior year and/or modify the restrictions on pro forma adjustments? If so, what changes should be made and should auditors have any level of involvement with the information? Are there disclosures we should consider adding to the Pro Forma Information that are currently found only in the Rule 3-05 Financial Statements?
 6. If we make changes to improve the usefulness of the Pro Forma Information, should we modify the requirement to provide Rule 3-05 Financial Statements? If so, how? If not, why?
 7. Should we modify the amount of time that registrants have to provide disclosures about acquired businesses to investors? If so, under what circumstances and how? If not, why?

8. Should certain registration statements continue to require accelerated and additional disclosure as compared to the Form 8-K requirements? If so, to what extent and why? If not, why?

2. Tests for Determining Disclosure Required by Rule 3-05 and Related Requirements

The Rule 3-05 tests employ bright-line percentage thresholds that a registrant must apply to a limited set of financial statement measures. Use of these thresholds provides registrants with certainty and promotes consistency. At the same time, they do not allow judgment to be applied to all of the facts and circumstances. In addition, the tests can be difficult to apply in certain situations and have not eliminated the need for implementation guidance.⁴¹ Commission staff receives frequent requests⁴² to consider anomalous disclosure outcomes, particularly resulting from application of the income test.⁴³

Request for Comment

9. Are significance tests the appropriate means to determine the nature, timing, and extent of disclosure under Rule 3-05 and the related requirements?
10. Are there changes or alternatives to the tests that we should consider to further facilitate the disclosure of useful information to investors? If so, what changes and are there challenges that registrants would face as a result?

⁴¹ Topic 2 of the Division of Corporation Finance's *Financial Reporting Manual* addresses several significance testing implementation issues including 1) acquisitions achieved in multiple stages; 2) acquisitions after a reverse merger; 3) aggregation of multiple individually insignificant acquisitions for a registration statement; 4) multiple acquisitions prior to an initial public offering; and 5) acquisitions of foreign businesses where the acquired company uses a different basis of accounting than the registrant.

⁴² During 2014, Commission staff received approximately 60 requests. The Commission has the authority under Rule 3-13 of Regulation S-X [17 CFR 210.3-13] to permit the omission of one or more of the financial statements required, and the Commission has delegated that authority to the staff.

⁴³ Anomalous results can occur, for example, when applying the income test where the registrant's income is at or near zero. An acquisition of a small entity, in terms of the asset and investment tests, may trigger Rule 3-05 disclosures as a result of the income test even if the acquired business has very modest income.

11. Are there changes to the tests we should consider to address challenges registrants face in preparing and providing the required disclosures? If so, what changes and how would those changes affect investors' ability to make informed decisions?
12. Should we revise the financial measures used to determine significance or change the percentage thresholds? For example, should we consider limiting the use of the income test and/or devise new tests such as purchase price compared to a registrant's market capitalization?
13. Should we allow registrants to apply more judgment in determining what is considered a significant acquisition? If so, why and how? What concerns might arise from allowing registrants to apply more judgment and, if allowed, should registrants disclose the rationale for the judgments?

Additional Request for Comment on Rule 3-05 and Related Requirements

14. Should we consider requiring foreign private issuers to provide disclosures similar to those provided by domestic companies when reporting on Form 8-K? Why or why not? Are there other issues that we should address related to acquisitions by foreign private issuers or acquisitions of foreign businesses?
15. Should smaller reporting companies and emerging growth companies be subject to the same requirements or should requirements for those registrants be scaled? If they should be scaled, in what way? If not, why?
16. Investment companies, and particularly business development companies, generally file Rule 3-05 Financial Statements in cases where the investment company is acquiring one or more private funds. This type of acquisition typically occurs early in the life of the investment company when it has little or no financial information of its own. In these

cases, Rule 3-05 Financial Statements of the private funds(s) may be the primary financial information considered by investors when making investment decisions with respect to the investment company. Should Rule 3-05 continue to apply to investment companies, or should investment companies be subject to different requirements? If so, how and why should the requirements be different? For example, should Rule 3-05 and the related requirements apply when an investment company purchases a significant portion of the assets of a fund, but not all of the assets and liabilities of the fund?

17. Should we align the definition of a business in Rule 11-01(d) with the definitions in the applicable accounting standards? Why or why not?

III. Rule 3-09 of Regulation S-X – Separate Financial Statements of Subsidiaries not Consolidated⁴⁴ and 50 Percent or Less Owned Persons and Related Requirements

A. Current Rule 3-09 Disclosure and Related Requirements

When a registrant owns 50 percent or less of an entity (“Investee”), Rule 3-09 of Regulation S-X generally requires the registrant to provide separate audited or unaudited annual financial statements (“Rule 3-09 Financial Statements”) of the Investee if it is significant.⁴⁵ The Rule 3-09 Financial Statements provide investors with detailed financial information about Investees that have a significant financial impact on the registrant through its investment, but are not subject to the disclosure requirements that would apply if it were a consolidated subsidiary. Insofar as practicable, the Rule 3-09 Financial Statements must be as of the same dates and for

⁴⁴ Commission staff has observed, based on filing reviews, that investment companies, particularly business development companies, may have unconsolidated subsidiaries not accounted for using the equity method, but other registrants typically do not. As a result, the body of this section focuses on requirements that apply to 50 percent or less owned persons accounted for using the equity method. Requirements applying to unconsolidated subsidiaries, not accounted for using the equity method, if different, are footnoted.

⁴⁵ Rule 3-09 does not apply to smaller reporting companies nor does Article 8 of Regulation S-X contain similar requirements.

the same periods as a registrant's annual financial statements.⁴⁶ Significance is determined using the tests defined in Rule 1-02(w) of Regulation S-X, although only the investment and income tests are used.⁴⁷ The Rule 3-09 tests can be generally described as follows:

- Investment Test - a registrant's investment in and advances to the Investee as of the end of each fiscal year presented by a registrant is compared to the total assets of the registrant at the end of each of those same years.
- Income Test - a registrant's equity in the Investee's income from continuing operations before income taxes and cumulative effect of a change in accounting principle, exclusive of amounts attributable to any noncontrolling interests, for each fiscal year presented by a registrant is compared to the same measure of the registrant for each of those same years.

If neither of the Rule 3-09 tests exceeds 20 percent, Rule 3-09 Financial Statements are not required. If at least one Rule 3-09 test exceeds 20 percent, Rule 3-09 Financial Statements are required for all years and must be audited for each year that a test exceeds 20 percent.⁴⁸

Separately, Rule 4-08(g) of Regulation S-X⁴⁹ requires disclosure, in the notes to a registrant's audited annual financial statements, of summarized balance sheet and income statement information on an aggregate basis for all Investees ("Summarized Financial Information").⁵⁰ These disclosures are only required if a Rule 3-09 test or an additional asset test⁵¹ exceeds 10 percent for any individual Investee or combination of Investees.⁵² If a

⁴⁶ Rule 3-09 does not require the presentation of separate interim financial statements of Investees.

⁴⁷ 17 CFR 210.3-09(a).

⁴⁸ Registrants with majority-owned subsidiaries that are not consolidated must perform the asset test in addition to the investment and income tests described in Rule 1-02(w). See Rule 3-09(a) of Regulation S-X.

⁴⁹ 17 CFR 210.4-08(g).

⁵⁰ 17 CFR 210.1-02(bb).

⁵¹ In 1994, Rule 3-09 was revised to eliminate the asset test; however, the test was retained for Rule 4-08(g) to ensure a minimum level of financial information about an investee when the investment test was small, but a registrant's proportionate interest in the Investee's assets was material, as might be the case for a highly-leveraged Investee. See *Financial Statements of Significant Foreign Equity Investees and Acquired*

registrant includes Rule 3-09 Financial Statements of an Investee in its annual report, then notes to the registrant's financial statements need not include Summarized Financial Information for that particular Investee.⁵³

Interim financial statements of a registrant must also include summarized income statement information of individually significant Investees.⁵⁴ Individual Investees are considered significant for purposes of this rule if a Rule 3-09 test, using interim period information, exceeds 20 percent.⁵⁵

The applicable accounting standards also require that the notes to the annual financial statements include summarized balance sheet and income statement information about equity-method investees.⁵⁶ Commission staff has observed, based on filing reviews, that registrants typically follow the Commission rules rather than making separate judgments under the applicable accounting standards.

Foreign Businesses of Domestic Issuers and Financial Schedules, Release No. 33-7118 (Dec. 13, 1994) [59 FR 65632].

⁵² A smaller reporting company must provide summarized information in its annual financial statements if a Rule 3-09 test or an additional asset test exceeds 20 percent, rather than 10 percent, for any individual Investee or combination of Investees. Although Article 8 of Regulation S-X does not include an explicit annual requirement analogous to Rule 4-08(g), Commission staff analogizes to Rule 8-03(b)(3) and typically issues a comment to request annual summarized information if it is not otherwise included. See § 2420.9 of the Division of Corporation Finance's *Financial Reporting Manual*.

⁵³ See Staff Accounting Bulletin Topic 6.K.4.b. The purpose of the summarized information is to provide minimum standards of disclosure when the impact of Investees on the consolidated financial statements is significant. If the registrant furnishes more financial information in the annual report than is required by these minimum disclosure standards, such as separate audited statements, the summarized information can be excluded.

⁵⁴ 17 CFR 210.10-01(b)(1).

⁵⁵ A smaller reporting company must provide summarized information in its interim financial statements pursuant to Rule 8-03(b)(3). Unless it is registering securities, a foreign private issuer need not provide interim information because it is not required to file quarterly financial information pursuant to Exchange Act Rules 13a-13 or 15d-13.

⁵⁶ FASB ASC 323, *Investments-Equity Method and Joint Ventures*, requires disclosure if material in relation to the financial position or results of operations of the registrant. Paragraphs B12 and B13 of IFRS 12, *Disclosure of Interests in Other Entities*, require similar disclosure.

B. Consideration of Current Rule 3-09 Disclosure and Related Requirements

1. Content of the Rule 3-09 Disclosure and Related Requirements

Financial disclosures required by our rules about an Investee are important to investors because the Investee can have a significant financial impact on a registrant. Also, the Investee is not consolidated so it is not subject to the same disclosure requirements that apply to consolidated subsidiaries. While it is important to provide information about Investees, the types of financial information currently required may have limitations and there may be opportunities for improvement. For example, Rule 3-09 Financial Statements may be presented using different accounting standards, fiscal year ends, and/or reporting currencies than those used by a registrant.⁵⁷ In addition, Rule 3-09 Financial Statements are required only for significant Investees rather than all Investees that may affect a registrant's financial statements. As a result, Rule 3-09 Financial Statements often cannot be reconciled to the amounts recognized in a registrant's financial statements for that Investee. The Summarized Financial Information also may not be reconcilable because the financial information of multiple Investees, each one with a different percentage owned by a registrant, can be aggregated in the presentation.

Summarized Financial Information is required more often⁵⁸ than Rule 3-09 financial statements and it also may have limitations. For example, the aggregate presentation, combined with the lack of reconciliation to amounts recognized in a registrant's financial statements, could diminish an investor's ability to discern the impact of significant Investees on a registrant's financial statements. This ability may be further diminished when Investees with income and Investees with losses are combined in the presentation.

⁵⁷ For example, when the Investee is a foreign business.

⁵⁸ Summarized Financial Information is required by Rule 4-08(g) when certain tests exceed 10%, while Rule 3-09 Financial Statements are required when certain tests exceed 20%.

Request for Comment

18. How do investors use each of the following: the Rule 3-09 Financial Statements; the Summarized Financial Information; and the interim disclosures? Are there challenges that investors face in using these disclosures?
19. Are there changes to these requirements we should consider to further facilitate the disclosure of useful information to investors? For example, is there different or additional information that investors need about Investees? If so, what information is needed and are there challenges that registrants would face in preparing and providing it?
20. Are there challenges that registrants face in preparing and providing the required disclosures? If so, what are the challenges? Are there changes to these requirements we should consider to address those challenges? If so, what changes and how would those changes affect investors' ability to make informed decisions?
21. Are there requirements that result in disclosures that investors do not consider useful? If so, what changes to these requirements would make them useful or should we consider eliminating or replacing all or part of those requirements?
22. How could we improve the usefulness of the Summarized Financial Information? Could we do so by adding a requirement to present separately each significant Investee and/or reconcile the disclosures to the amounts recognized in a registrant's financial statements? Are there disclosures we should consider adding that are currently found only in Rule 3-09 Financial Statements?
23. If we make changes to improve the usefulness of the Summarized Financial Information, would it be appropriate to modify the requirement to provide Rule 3-09 Financial Statements? If so, how? If not, why?

24. Are unaudited Rule 3-09 Financial Statements and Summarized Financial Information for fiscal years during which an Investee was not significant useful to investors? Why or why not?

2. Tests for Determining Disclosure Required by Rule 3-09 and Related Requirements

The tests used for determining disclosure pursuant to Rule 3-09 and the related requirements employ bright-line percentage thresholds similar to Rule 3-05. In addition, the use of these tests to determine the need for disclosure in interim financial statements is different than the other financial statement footnote disclosure requirements specified in Rule 10-01(a)(5) of Regulation S-X.⁵⁹ Rule 10-01(a)(5) allows registrants to apply judgment and omit details of accounts which have not changed significantly in amount or composition since the end of the most recently completed fiscal year.

Additionally, investment companies may face challenges when applying the income test. The numerator of the income test, as defined in Rule 1-02(w) of Regulation S-X, includes the registrant's equity in the Investee's income from continuing operations; however, investment companies account for their Investees using fair value rather than the equity method. The denominator used for the test includes changes in the fair value of investments that can cause the denominator to fluctuate significantly. As a result, registrants frequently consult with Commission staff about anomalous results.

Request for Comment

25. Are significance tests the appropriate means to determine the nature, timing, and extent of disclosure under Rule 3-09 and the related requirements?

⁵⁹ 17 CFR 210.10-01(a)(5).

26. Are there changes or alternatives to the tests that we should consider to further facilitate the disclosure of useful information to investors? If so, what changes and are there challenges that registrants would face as a result?
27. Are there changes to the tests that we should consider to address challenges that registrants face in preparing and providing the required disclosures? If so, what changes and how would those changes affect investors' ability to make informed decisions?
28. Should we allow more judgment to be applied by registrants in determining significance? Why or why not? What concerns might arise from allowing registrants to apply more judgment and, if allowed, should registrants disclose the rationale for the judgments?
29. Should we revise the current percentage thresholds and/or the financial measures used to determine significance? For example, should we consider limiting the use of the income test or devise new tests?
30. Should we consider revising the requirements to provide interim disclosures about Investees to focus on significant changes similar to Rule 10-01(a)(5) of Regulation S-X, which allows registrants to apply judgment and omit details of accounts that have not changed significantly in amount or composition since the end of the most recently completed fiscal year? Why or why not?

Additional Request for Comment on Rule 3-09 and Related Requirements

31. Should smaller reporting companies and emerging growth companies be subject to the same requirements or should requirements for those registrants be scaled? If they should be scaled, in what way? If not, why?
32. Should investment companies, particularly business development companies, be subject to different requirements? If so, how and why should the requirements be different? For

example, should the significance tests be modified to apply measures other than the income test or asset test that are more relevant to investment companies? Should there be a different income test related to investment companies? Should we tailor the disclosures provided by unconsolidated subsidiaries of investment companies further by, for example, creating separate requirements for Summarized Financial Information and/or requiring a schedule of investments for unconsolidated subsidiaries not accounted for as investment companies⁶⁰ that are in similar lines of business?

IV. Rule 3-10 of Regulation S-X – Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered

A. Current Rule 3-10 Disclosure and Related Requirements

A guarantor of a registered security is an issuer because the guarantee of a security is a separate security.⁶¹ As a result, both issuers of registered securities that are guaranteed and guarantors of registered securities must file their own audited annual and unaudited interim⁶² financial statements required by Regulation S-X.⁶³ Rule 3-10 of Regulation S-X provides certain exemptions⁶⁴ from those financial reporting requirements and is commonly relied upon by a parent company when it raises capital through: 1) an offering of its own securities guaranteed by one or more of its subsidiaries; or 2) an offering of securities by its subsidiary that it guarantees and, sometimes, that one or more of its other subsidiaries also guarantees. Under Rule 3-10, if the subsidiary issuers and guarantors (“issuers/guarantors”) satisfy specified conditions, the

⁶⁰ Rule 3-09 Financial Statements for unconsolidated subsidiaries accounted for as investment companies are required to include the schedules required by Rule 6-10 of Regulation S-X.

⁶¹ See Section 2(a)(1) of the Securities Act.

⁶² A foreign private issuer need only provide interim period disclosure in certain registration statements.
⁶³ 17 CFR 210.3-10(a).

⁶⁴ Rule 3-10 exemptions are available to issuers/guarantors of securities that are “debt or debt-like.” See *Financial Statements and Periodic Reports for Related Issuers and Guarantors*, Release No. 33-7878 (August 4, 2000) [65 FR 51692].

parent company can provide disclosures in its own annual and interim consolidated financial statements in lieu of providing financial statements of each subsidiary issuer and guarantor (“Alternative Disclosures”).

The Alternative Disclosures are available in a variety of fact patterns. The rule addresses six specific fact patterns, two of which are:

- a single subsidiary guarantees securities issued by its parent;⁶⁵ and
- an operating subsidiary issues securities guaranteed only by its parent.⁶⁶

All fact patterns must satisfy two primary conditions to qualify for the Alternative Disclosure. First, the subsidiary issuers/guarantors must be “100% owned”⁶⁷ by the parent company. Second, the guarantees must be “full and unconditional.”⁶⁸ Once those two conditions are met, the form and content of the Alternative Disclosure is determined based upon additional conditions. For example, in the fact patterns above, the parent company can provide abbreviated narrative disclosure in its financial statements if: 1) it has no independent assets or operations⁶⁹ and 2) all of its subsidiaries other than the issuer or guarantor, depending on the fact pattern, are minor.⁷⁰ Otherwise, the parent company must provide the more detailed condensed consolidating financial information (“Consolidating Information”) described below.

⁶⁵ 17 CFR 210.3-10(e).

⁶⁶ 17 CFR 210.3-10(c).

⁶⁷ 17 CFR 210.3-10(h)(1). A subsidiary is “100% owned” if all of its outstanding voting shares are owned, either directly or indirectly, by its parent company. A subsidiary not in corporate form is 100% owned if the sum of all interests are owned, either directly or indirectly, by its parent company other than: 1) securities that are guaranteed by its parent, and, if applicable, other 100%-owned subsidiaries of its parent; and 2) securities that guarantee securities issued by its parent and, if applicable, other 100%-owned subsidiaries of its parent.

⁶⁸ 17 CFR 210.3-10(h)(2). A guarantee is “full and unconditional,” if, when an issuer of a guaranteed security has failed to make a scheduled payment, the guarantor is obligated to make the scheduled payment immediately and, if it does not, any holder of the guaranteed security may immediately bring suit directly against the guarantor for payment of all amounts due and payable.

⁶⁹ 17 CFR 210.3-10(h)(5).

⁷⁰ 17 CFR 210.3-10(h)(6).

Consolidating Information is a columnar footnote presentation of each category of parent and subsidiaries as issuer, guarantor, or non-guarantor.⁷¹ It must include all major captions of the balance sheet, income statement, and cash flow statement that are required to be shown separately in interim financial statements under Article 10 of Regulation S-X.⁷² In order to distinguish the assets, liabilities, operations and cash flows of the entities that are legally obligated to make payments under the guarantee from those that are not, the columnar presentation must show: 1) a parent company's investments in all consolidated subsidiaries based upon its proportionate share of the net assets;⁷³ and 2) subsidiary issuer/guarantor investments in certain consolidated subsidiaries using the equity method.⁷⁴ This presentation is a unique format designed to ensure, for example, that a subsidiary guarantor does not consolidate, within this presentation, its own non-guarantor subsidiary.

Recently-acquired subsidiary issuers/guarantors create an information gap in the Consolidating Information because the subsidiaries will only be included from the date that the subsidiaries were acquired. The Securities Act registration statement of a parent company⁷⁵ must include one year of audited pre-acquisition financial statements for these subsidiaries in its registration statement if: 1) the subsidiary is significant; and 2) the subsidiary is not reflected in the audited consolidated results for at least nine months of the most recent fiscal year.⁷⁶ A subsidiary is significant if its net book value or purchase price, whichever is greater, is 20 percent or more of the principal amount of the securities being registered.

⁷¹ 17 CFR 210.3-10(i)(6).

⁷² 17 CFR 210.10-01(a).

⁷³ 17 CFR 210.3-10(i)(3).

⁷⁴ 17 CFR 210.3-10(i)(5).

⁷⁵ Filed in connection with the offer and sale of the debt or debt-like securities.

⁷⁶ 17 CFR 210.3-10(g)(1).

Issuers/guarantors availing themselves of the exemption that allows for Alternative Disclosure are automatically exempt from Exchange Act reporting by Exchange Act Rule 12h-5.⁷⁷ The parent company, however, must continue to provide the Alternative Disclosure for as long as the guaranteed securities are outstanding.⁷⁸ The parent company may not cease to report this information even at such time that the subsidiary issuers/guarantors, had they declined to avail themselves of the exemptions and reported separately, could have suspended their reporting obligations under Section 15(d) of the Exchange Act.⁷⁹

B. Consideration of Current Rule 3-10 Disclosure and Related Requirements

1. Content of the Rule 3-10 Alternative Disclosure

Separate financial disclosures required by our rules about issuers of guaranteed debt and guarantors of those securities are important to investors because the disclosures allow investors to evaluate separately the likelihood of payment by the issuer and guarantors. The content of the Alternative Disclosure, despite being less robust than financial statements required by Regulation S-X, is detailed and unique. For example, the Consolidating Information includes all major captions that are found in quarterly reports filed on Form 10-Q⁸⁰ and must be prepared using a unique format that is not found elsewhere in Commission rules or the applicable accounting standards. A parent company may also need to provide, in a registration statement, pre-acquisition financial statements of significant, recently-acquired subsidiary issuers/guarantors. These financial statements are required even if those subsidiaries will qualify for the Alternative

⁷⁷ 17 CFR 240.12h-5.

⁷⁸ Section III.C.1 of Release No. 33-7878 (August 4, 2000) [65 FR 51692].

⁷⁹ 15 U.S.C. 78o(d).

⁸⁰ 17 CFR 249.308a.

Disclosure once included in a registrant's audited consolidated results for nine months of the most recent fiscal year.

Request for Comment

33. How do investors use the information provided in financial statements of subsidiary issuers/guarantors and the information provided in the Alternative Disclosure? Are there challenges that investors face in using the disclosures?
34. Are there changes to these requirements we should consider to further facilitate the disclosure of useful information to investors? For example, is there different or additional information that investors need about guarantors and issuers of guaranteed securities? If so, what information is needed and are there challenges that registrants would face in preparing and providing it?
35. Are there challenges that registrants face in preparing and providing the required disclosures? If so, what are the challenges? Are there changes to these requirements we should consider to address those challenges? If so, what changes and how would those changes affect investors' ability to make informed decisions?
36. Are there requirements that result in disclosures that investors do not consider useful? If so, what changes would make them useful or should we consider eliminating or replacing all or part of those requirements?
37. How could we improve the usefulness of the Consolidating Information? Could we do so by revising its content requirements? If so, what changes should be made and why?
38. Should we consider revising the requirement to provide Consolidating Information for interim periods to focus on significant changes similar to Rule 10-01(a)(5) of Regulation S-X, which allows registrants to apply judgment and omit details of accounts that have

not changed significantly in amount or composition since the end of the most recently completed fiscal year? Why or why not?

39. Is there other disclosure that would allow us to modify the requirement for separate, audited financial statements of recently-acquired subsidiary issuers/guarantors that would be useful to investors? If so, what disclosure would be appropriate and in what circumstances? If not, why?

2. Conditions to Providing Alternative Disclosure

As stated above, one of the primary conditions that must be met for a parent company to provide the Alternative Disclosure is that the subsidiary issuers/guarantors are “100% owned.” For example, the Alternative Disclosure is not available if a subsidiary is organized in a jurisdiction that requires directors to own a small number of shares unless the registrant obtains relief from Commission staff.⁸¹ The condition is intended to ensure the risks associated with an investment in a parent company and the risks associated with its subsidiary are “identical.”⁸² Similarly, “full and unconditional” is intended to ensure the payment obligations of the issuer and guarantor are “essentially identical.”⁸³ Registrants may not provide the Alternative Disclosure unless the guarantee operates such that, when an issuer of a guaranteed security has failed to make a scheduled payment, the guarantor is obligated to make the scheduled payment immediately and, if it does not, any holder of the guaranteed security may immediately bring suit directly against the guarantor for payment of all amounts due and payable. For example, registrants are not allowed to use the Alternative Disclosure when guarantees become enforceable after the passage of some time period after default. These are precise standards that

⁸¹ Release No. 33-7878 (Aug. 4, 2000) [65 FR 51692, fn. 29].

⁸² Id.

⁸³ Id.

must be met in order to reduce disclosure from, for example, full financial statements to the detailed and unique Consolidating Information.

Separately, the duration of the obligation to provide the Alternative Disclosure is different than the obligation to provide separate financial statements. To obtain the exemption under Rule 12h-5, a parent company must provide the Alternative Disclosures as long as the securities are outstanding, while the obligation to provide separate financial statements can be suspended earlier as provided in Section 15(d) of the Exchange Act.

Request for Comment

40. Do the current conditions to providing the Alternative Disclosure influence the structure of guarantee relationships? If so, how and what are the consequences, if any, to investors and registrants?
41. Should we consider allowing a parent company to provide the Alternative Disclosure if its subsidiary issuers or guarantors do not meet the current definition of 100% owned? If so, how should we revise the Alternative Disclosure conditions and what additional disclosure might address concerns about the presence of outside ownership interests? If not, why?
42. Should we consider allowing a parent company to provide the Alternative Disclosure if a guarantee does not meet the current definition of full and unconditional? If so, how should we revise the Alternative Disclosure conditions? Should we consider, for example, allowing the Alternative Disclosure for guarantees that become enforceable after the passage of some time period after default? What additional disclosure might address concerns about the delayed enforceability? If not, why?

43. Should we consider revising the conditions that must be satisfied to qualify for the abbreviated narrative disclosure? If so, how? If not, why?
44. Should we modify the parent company's requirement to provide the Alternative Disclosure during the period in which the securities are outstanding? If so, how? If not, why?

Additional Request for Comment on Rule 3-10 and Related Requirements

45. Should smaller reporting companies and emerging growth companies be subject to the same requirements or should requirements for those registrants be scaled? If they should be scaled, in what way?

V. Rule 3-16 of Regulation S-X – Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered

A. Current Rule 3-16 Disclosure and Related Requirements

Rule 3-16 of Regulation S-X requires a registrant to provide separate annual and interim financial statements for each affiliate⁸⁴ whose securities constitute a substantial portion of the collateral for any class of securities registered or being registered as if the affiliate were a separate registrant ("Rule 3-16 Financial Statements").⁸⁵ The affiliate's portion of the collateral is determined by comparing: a) the highest amount among the aggregate principal amount, par value, book value, or market value of the affiliates' securities to b) the principal amount of the

⁸⁴ 17 CFR 210.1-02(b) states, "An *affiliate* of, or a person *affiliated* with, a specific person is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified." Although not the same, in practice such affiliates are almost always consolidated subsidiaries of the registrant.

⁸⁵ Both domestic registrants and foreign private issuers need only provide interim period information in certain registration statements.

securities registered or being registered. If this test equals or exceeds 20 percent for any fiscal year presented by a registrant, Rule 3-16 Financial Statements are required.⁸⁶

Separately, Rule 4-08(b) of Regulation S-X⁸⁷ requires disclosure, in the notes to a registrant's annual financial statements, of the amounts of assets mortgaged, pledged, or otherwise subject to lien.

B. Consideration of Current Rule 3-16 Disclosure and Related Requirements

Disclosures required by our rules that facilitate an evaluation of an affiliate's ability to satisfy its commitment in the event of a default by a registrant are important to investors. Rule 3-16 requires financial statements as though the affiliate were a registrant despite the fact that the collateral pledge is not considered a separate security. Also, registrants have suggested, in consultations with Commission staff, that the Rule 3-16 Financial Statements can be confusing. For example, where the securities of a subsidiary of a registrant ("Subsidiary A") are pledged as collateral and the securities of an entity consolidated by Subsidiary A ("Subsidiary B") are also pledged, Rule 3-16 Financial Statements may be required for both subsidiaries and both will include Subsidiary B's assets, liabilities, operations, and cash flows.

The test used in applying Rule 3-16 employs a bright-line percentage threshold that a registrant must apply to a limited set of measures similar to Rules 3-05 and 3-09. Unlike those rules, the market value of an affiliate's securities may not be readily available in the absence of a public market for those securities.

⁸⁶ 17 CFR 210.3-16(b).

⁸⁷ 17 CFR 210.4-08(b).

Request for Comment

46. Do the Rule 3-16 requirements influence the structure of collateral arrangements? If so, how and what are the consequences, if any, to investors and registrants?
47. How do investors use Rule 3-16 Financial Statements and the Rule 4-08(b) footnote disclosures? Are there challenges that investors face in using the disclosures?
48. Are there changes to these requirements we should consider to further facilitate the disclosure of useful information to investors? For example, is there different or additional information that investors need about affiliates whose securities collateralize registered securities? If so, what information is needed and are there challenges that registrants would face in preparing and providing it?
49. Are there challenges that registrants face in preparing and providing the required disclosures? If so, what are the challenges? Are there changes to these requirements we should consider to address those challenges? If so, what changes and how would those changes affect investors' ability to make informed decisions?
50. Are there requirements that result in disclosures that investors do not consider useful? If so, what changes would make them useful or should we consider eliminating or replacing all or part of those requirements?
51. How could we improve the usefulness of the Rule 4-08(b) footnote disclosure? Could we do so by adding a requirement to disclose additional details about the affiliates? If so, what additional details should we require?
52. If we make changes to improve the usefulness of the footnote disclosure, would it be appropriate to modify the requirement to provide Rule 3-16 Financial Statements? If so, how? If not, why?

53. Should we revise the test used in applying Rule 3-16? If so, how? If not, why?

Additional Request for Comment on Rule 3-16 and Related Requirements

54. Should smaller reporting companies and emerging growth companies continue to be subject to the same requirements or should requirements for those registrants be scaled? If they should be scaled, in what way? If not, why?

VI. Other Requirements

In addition to the issues raised in this request for comment, we encourage all interested persons to submit their views on any issues relating to the financial information about entities, or portions of entities, other than a registrant. For example, Rule 3-14, *Special Instructions for Real Estate Operations to be Acquired*,⁸⁸ while separate and distinct from Rule 3-05, is intended to achieve similar objectives within a particular industry. In addition, Item 2.01 of Form 8-K uses significance tests to determine when to provide disclosure about asset acquisitions. The requirements addressed in this request for comment may apply more broadly than the situations described. To the extent there may be additional effects, please provide comments.

Request for Comment

55. As we continue our ongoing efforts to review disclosure rules, what other rules and forms should be considered for review and why?
56. Currently, financial disclosures related to entities other than a registrant are filed in XBRL format to the extent that they are part of the registrant's financial statements.⁸⁹ Other disclosures, such as the separate financial statements of entities other than the registrant and Pro Forma Financial Information are not required to be presented in a

⁸⁸ 17 CFR 210.3-14.

⁸⁹ For example, the Summarized Financial Information required by Rule 4-08(g) of Regulation S-X and the Consolidating Information required by Rule 3-10 of Regulation S-X.

structured, machine-readable format. Would investors benefit from having all of the disclosures related to these entities made in an interactive data format? Would it depend on the nature of the information being disclosed (e.g., disclosure related to a one-time transaction such as an acquisition or ongoing disclosure related to an Investee)? What would be the cost to registrants?

57. In what other ways could we utilize technology to further facilitate the disclosure of useful information to investors or address challenges faced by investors and registrants?
58. Are there ways that we could further facilitate the use of information by all types of investors? If so, please explain. For example, should we consider alternative ways of presenting the information, such as specifically allowing or requiring registrants to provide a summary along with more detailed required information to enable investors to review the information at the level of detail that they prefer?

VII. Closing

This request for comment is not intended in any way to limit the scope of comments, views, issues or approaches to be considered. In addition to investors and registrants, the Commission welcomes comment from other market participants and particularly welcomes statistical, empirical, and other data from commenters that may support their views and/or support or refute the views or issues raised.

By the Commission.

Dated: September 25, 2015

Robert W. Errett
Deputy Secretary

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